Internal Revenue Service

memorandum

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Br1:MLTorri

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to: Special Trial Attorney, Chicago/ISP Railroad Counsel CC:CHI
Beth L. Williams/Robert Fowler

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in response to your memorandum dated September 20, 1988, and supplementary memorandum dated October 19, 1988, requesting technical advice on the litigating position to be taken with respect to the taxpayer referenced above.

ISSUE

Whether the Service should litigate the includibility of indirect maintenance costs attributable to superintendence and small tools in the expenditures to which the repair allowance percentage applies for asset guideline classes 40.1 and 40.2. 0167-2500; 0263-1400.

CONCLUSION

We agree that the hazards of litigating this issue against this taxpayer are decidedly against the Service. We therefore recommend concession.

FACTS

Taxpayer, [redacted] ("[redacted]"), operates the [redacted] and [redacted]. The railroad is regulated by the Interstate Commerce Commission ("ICC") and is mandated by ICC regulations to maintain its accounts according to the Uniform System of Accounts for Railroads. This system designates specific asset accounts and corresponding operating expense accounts, as well as various operating expense accounts which record indirect or overhead expenditures unrelated to any specific asset account ("ICC accounts").

[redacted] made proper repair allowance elections under Treas. Reg. § 1.167(a)-11(d) for [redacted] and [redacted] for asset guideline classes 40.1 and 40.2. During those years, the repair allowance

percentage for asset guideline class 40.1 was 10.5% and for asset guideline class 40.2 was 5%. [redacted] was required to capitalize the excess of repair expenditures over these allowances. In computing the expenditures subject to the repair allowance percentage for each asset guideline class, [redacted] included only direct costs assigned to certain of the railway operating expense accounts. Over and above the repair allowance percentage permitted under Treas. Reg. § 1.167(a)-11(d)(2), [redacted] deducted as ordinary operating expenses all of the indirect costs identified in the railway operating expense accounts for the maintenance of roadway and structures (200 series of ICC accounts) or the maintenance of equipment (300 series of ICC accounts).

Upon audit, Examinations proposed adjustments for [redacted] and [redacted] on the basis that these indirect expenses should have been included in the repair allowances, and thus were not separately deductible. The proposed adjustments would have required the inclusion of indirect expenses reflected in the following ICC accounts: Accounts 201 and 301 (superintendence); Account 271 (small tools and supplies); Accounts 274 and 332 (injuries to persons); Accounts 275 and 333 (insurance); Accounts 276 and 334 (stationery and printing); Accounts 277 and 335 (employees' health and welfare benefits); and Accounts 282 and 339 (other expenses).

[redacted] has consistently maintained that the repair allowance percentage was based on industry data consisting solely of the direct maintenance expense accounts, and did not consider indirect costs in determining the repair allowance percentages. In an identical case involving another member of the [redacted] consolidated group, the [redacted], 1/ this issue was submitted for technical advice by the District Director, San Francisco on March 28, 1980. The initial National Office Technical Advice Memorandum held that none of the disputed ICC accounts should be included in the repair allowance. The request for technical advice was resubmitted, and a second NOTA was issued on October 28, 1981. The second NOTA (a verbatim repetition of CLADR System Repair Allowance, GCM 38788, I-229-80 (Aug. 26, 1981)) concluded that the railroad must include the indirect cost of supervisory employees (Accounts 201 and 301) and small tools and supplies (Account 271) in repair allowance expenditures, and concluded that the railroad need not include the other indirect costs as had been proposed. However, the notice of deficiency which was subsequently issued required inclusion not only of

1/ [redacted] was a consolidated group member of [redacted], and [redacted] is controlling the tax issues for both taxpayers.

Accounts 201 and 301 (superintendence) and Account 271 (small tools), but also included Accounts 274 and 332 (injuries to persons) in repair expenditures. Consistent with GCM 38788, counsel will concede the allocations of the personal injury accounts.

DISCUSSION

The purpose of the Class Life Asset Depreciation Range system ("CLADR") is to gear forecasts of anticipated useful life and repair allowances to industry norms. CLADR was administratively adopted in 1971 and received Congressional sanction by the Revenue Act of 1971, which enacted I.R.C. §§ 167(m) and 263(e). Proposed regulations were published on January 27, 1972. Section 1.167(a)-11(d)(2)(i)(b) of the proposed regulations contained a provision that would have specified the costs which were includible in the repair allowance. The proposed section provided in relevant part:

> 1.167(a)-11(d)
>
> (2) Treatment of repairs--(i) In general.
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> * * *
>
> (b) The amount paid or incurred for the repair, maintenance, rehabilitation or improvement of eligible property ... shall include only costs (direct or indirect) identified or associated with the repair, maintenance, rehabilitation or improvement of such property. Such expenditures in general include the cost paid or incurred for the services of third parties and the cost of self-performed repair, maintenance, rehabilitation or improvement. In the latter case, the expenditures in general include the cost of direct labor and the cost of direct materials used in the repair, maintenance, rehabilitation or improvement of such property, as well as an allocable portion of indirect cost associated therewith. Such expenditures need not, however, include such indirect costs as state, local and foreign taxes, depreciation and depletion, pension and

> profit-sharing contributions and other employee benefits, officers' salaries, and general and administrative expenses except to the extent the taxpayer allocates such costs to repair, maintenance, rehabilitation or improvement for purposes of financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes. ...

(Emphasis added). The proposed section also gave the taxpayer an option to include indirect costs without regard to whether they were included for financial purposes. Prop. Reg. § 1.167(a)-11(d)(2)(i)(b) appears to have been modeled after the capitalization rules and the full absorption method of inventory costing in Treas. Reg. § 1.471-11.

The withdrawal and reservation of paragraph (d)(2)(i)(b) followed the public comment period during which numerous taxpayers in regulated industries voiced objection to the conformity requirement in the proposed regulation. This requirement was viewed as discriminatory against regulated taxpayers which are required to include indirect costs in their repair expenditures for financial reporting purposes. The final regulation makes no reference to indirect costs. We have made an extensive search of the regulation back-up file 2/ and have been unable to locate any document specifically addressing the issue whether the Service intended by the withdrawal of this provision to abandon the requirement that indirect costs were to be included in the expenditures subject to the repair allowance percentage. Only one document makes reference to the matter, but does not resolve the question of the Service's intention. In a memorandum dated March 2, 1973, transmitting the final regulations for publication, the Commissioner advised the Assistant Secretary of the Treasury for Tax Policy:

> The proposed Treasury decision withdraws § 1.167(a)-11(d)(2)(i)(b) as announced in Technical Information Release 1171. That portion of the proposed regulations would have conditioned the Federal income tax treatment of certain indirect costs associated with the repair, maintenance, rehabilitation or improvement of property upon the taxpayer's treatment of such expenditures in his

2/ Unfortunately, two of the file folders in L.R. 1944 have been lost. We were able to review only four of the six original files.

> financial reports. Although as a matter of policy, it has been determined that the taxpayer's treatment of these indirect costs in his financial reports should not determine their tax treatment for Federal tax purposes, rules regarding the treatment of such expenditures have not been developed at this time. This question is currently in litigation in William K. Coors, et. al. v. Commissioner, Docket Nos. 2837-69, 2839-69, and Idaho Power Company v. Commissioner, T.C. Memo 1970-83, now on appeal to the 9th Circuit.

Neither case referred to in the Commissioner's memorandum addressed the includibility of indirect costs in the repair deduction. At issue in both cases was the capitalization of indirect costs in self-constructed assets. The logical inference from the Commissioner's reference to these two cases is that the inclusion of indirect costs in the repair allowance percentage had not been abandoned as a policy matter.

[redacted], while arguing that the absence of any reference to indirect costs in the final regulations has substantial significance, contends that the crucial issue in this case is not what cost elements should have been included in the original repair allowance percentages for asset guideline classes 40.1 and 40.2, but rather, what cost elements were in fact included in the repair allowance percentages as initially adopted. We agree. The issue was framed in GCM 38788:

> There still remains for consideration, the working relationship between the computation of the repair allowance expenditures and the repair allowance percentage. The purpose of the percentage is to measure the amount of the expenditures that are currently deductible without question. Therefore, in order to avoid both distortion of income and distortion of the capital accounts, it is important that both sides of the equation, that is, the computation of the repair allowance expenditures and the repair allowance percentage, which measure the deductible amount of those expenditures, include the same elements. Otherwise, if an item (for example, overhead) is included in computing the expenditures, but excluded in computing the percentage, the result would be to require capitalization of amounts that should be deducted ... .

(Emphasis added). Notwithstanding that the GCM acknowledges this to be the essential inquiry, and recognizes that "[l]ittle appears to be known about the composition of the pre-[redacted] repair percentages," the GCM nevertheless goes on to speculate that salaries of supervisors (reflected in ICC Accounts 201 and 301) could not have been overlooked in setting the original repair allowance percentage. The GCM concludes that the expenditures for small tools accounted for in Account 271 are "classic direct costs" and "classification of such costs as indirect on the railroad's books should not effect [sic] their tax treatment for repair allowance purposes." On these assumptions, the GCM concludes that these costs should be included in the computation of railroad repair allowance expenditures. Because the conclusions of GCM 38788 are based upon speculation about the cost elements that were considered in establishing the initial repair allowance percentages, we have serious doubts about its defensibility. We would prefer a litigating position based upon the actual industry data considered in arriving at the percentages for asset guideline classes 40.1 and 40.2.

The repair allowance percentage concept was Congressionally authorized by former section 263(e), which provided that "any allowance prescribed under this subsection shall reflect the anticipated repair experience of the class of property in the industry or other group." The legislative history of this provision indicates Congress' intent that "the repair allowances [would] be developed and modified by the Treasury on the basis of data collected by it regarding the repair experience of the industry or other group with respect to the class of property." H.R. Rep. No. 533, 92d Cong., 1st Sess. (1971), reprinted in 1971 U.S. Code Cong. & Ad. News 1825, 1846. To discharge this responsibility, the Office of Industrial Economics ("OIE") was established in August 1971 to accumulate and compile industry data. Dr. Seymour Fiekowsky was detailed from Treasury to the Service to serve as OIE's first Director. [redacted].

All records relating to OIE's original study of the railroads' repair and maintenance experience were routinely destroyed. 3/ Thus, no documentary evidence exists to confirm or deny that OIE considered indirect costs in computing the initial repair allowance percentages for asset guideline classes 40.1 and 40.2. However, [redacted] has indicated to [redacted]

3/ It appears that prior to the destruction of these records, [redacted] had made a request under the Freedom of Information Act for all of the data contained in the original OIE study of the railroad industry.

that he is prepared to testify that indirect costs were not intended to be included in the repair allowances. Moreover, as you noted in your memorandum of October 19, 1988, the available studies of other industries suggest that OIE made little or no conscious effort to include indirect or superintendence costs in establishing the repair allowance percentages for those industries, which lends credence to [redacted]'s proposed testimony.

The repair allowance percentage for class 40.1 was revised upward in 1979. The new percentage resulted from a study conducted by Mr. Thomas A. Thompson. The Thompson study specifically identified the ICC maintenance accounts which were considered. Accounts 201, 301 and 271 were not among the enumerated accounts. While there is no evidence that the Thompson study used the same or a different methodology than used in the original OIE study, it tends to support [redacted] contention that the data submitted to OIE by the railroad industry conformed to the ICC accounts system and did not include expenditures stated in overhead or indirect cost accounts. The Thompson study compared maintenance data on the railroads' annual reports filed with the ICC to the repair expenditures reported by the railroads on Form 4832 filed with their tax returns. The high correlation between the CLADR repair figures and the ICC maintenance figures suggests relative uniformity of reporting repair experience within the railroad industry, and further suggests that the industry's submission of data to OIE included only those expenditures reported in the ICC direct cost accounts.

The issue of whether certain indirect costs should be included in the expenditures subject to the repair allowance percentage was raised in Armco, Inc. v. Commissioner, 88 T.C. 946 (1987), in the context of the ferrous metals industry. However, because the court disposed of the case on other issues, it did not consider what cost elements should be included in the data base to which the repair allowance percentage applied. The court allowed the taxpayer to revoke its election to use the repair allowance percentage after finding that the original repair allowance percentage for ferrous metals was computed using a flawed methodology and was inadequate to reflect the repair experience of the industry.

Unlike the taxpayer in Armco, [redacted] does not contend that the erosion of the original repair allowance percentage between [redacted] and [redacted] invalidates its election, nor does it contend that OIE's methodology in determining the original percentage was flawed. Instead, [redacted] argues that requiring the inclusion of the costs in Accounts 201, 301 and 271 in the repair expenditure base goes beyond the cost elements considered by OIE in establishing the original repair alloowance percentages for the railroad industry.

Although the issue is framed differently than in [redacted], we nevertheless see this case as presenting substantial litigating hazards. By telephone conference on October 18, 1988, and supplemental memorandum dated October 19, 1988, you advised us that [redacted] v. Commissioner has been set for trial on the [redacted] calendar and has been assigned to Judge [redacted]. In light of Judge [redacted]' insistence in [redacted] that the repair allowance percentage must, by Congressional mandate, reflect actual industry repair experience, we believe he would be unfavorably disposed toward the Service in [redacted] if we could not produce OIE's original studies of railroad repair expenditures.

In light of all of the factors discussed above, we agree that concession of this case is appropriate, although it is inconsistent with GCM 38788.

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